Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D. C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of	)	
	)	
Implementation of the Telecommunications Act of 1996	)	
	)	
	)	CC Docket No. 96-150
Accounting Safeguards Under the Telecommunications Act of 1996	)	
	)	

Comments of BellSouth

BELLSOUTH TELECOMMUNICATIONS, INC.
BELLSOUTH CORPORATION

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SUMMARY

In the Telecommunications Act of 1996, Congress charged the Commission with implementing a procompetitive, deregulatory national policy in telecommunications. Section 10 of the 1996 Act mandates that unnecessary regulation be eliminated as soon as the public interest permits. While numerous sections of the new Act charge the Commission with maintaining such accounting safeguards as are necessary to protect consumers and competitors against subsidization and discrimination, in each case the Commission is left with discretion to adopt and maintain only those rules that are necessary to protect the public interest.

The primary focus of this docket is the accounting safeguards that will apply when the former Bell Operating Companies ("BOCs") enter lines of business previously foreclosed to them under the 1982 AT&T Consent Decree. To properly implement Congress' intent, the Commission must look at each accounting safeguard, both existing and proposed, to see whether it is necessary and whether the public benefit of each such requirement outweighs its cost. Since compliance costs absorb inputs without increasing output, the Commission must be cognizant of the fact that each dollar spent complying with accounting safeguards is a dollar of lost productivity.

The Commission must also look at the proposed rules in context, not in isolation. The BOCs and other large incumbent local exchange carriers ("ILECs") have been subject to price cap regulation for years. That regulatory plan was specifically designed to eliminate the incentive and ability of the ILECs to shift costs to consumers of regulated services. Price cap regulation provides an unambiguous incentive for the ILECs to reduce costs, improve productivity, and price efficiently. The fact that the LEC price cap plan is

imperfect, largely because the Commission has been unwilling to eliminate the last vestiges of rate of return regulation, does not alter the essential fact that price cap LECs have a strong incentive to operate efficiently and improve productivity in order to improve their earnings. That incentive structure is central to the need (or lack thereof) for accounting safeguards. It is disappointing that the interaction between price cap regulation and cost allocation rules was discussed only superficially in the last few pages of the Notice.

In these comments, BellSouth demonstrates that cost allocation rules imposed by regulators are inconsistent with the way markets allocate costs. In competitive markets, prices are set by the interaction of the forces of supply and demand. Joint and common costs are absorbed in varying shares by the firm's product lines as market forces permit. By contrast, cost allocations imposed by regulators are economically arbitrary, and prices set on the basis of such costs do not have either static or dynamic efficiency properties. It was precisely to eliminate the efficiency-robbing distortions inherent in cost of service regulation, with its reliance on accounting costs to set prices, that price cap regulation was adopted.

Cost allocation and affiliate transaction rules can have one of two effects in a price cap environment. To the extent that they do not trigger a change in the price cap, and hence do not effect prices charged consumers, they are superfluous. They provide no additional protection for consumers that were not already provided by the price cap plan itself. Under such circumstances, the lost productivity spent complying with such rules is wasted, and reduces overall consumer welfare. To the extent that such rules do effect the prices charged to consumers, they do so in a way that reduces economic efficiency and reintroduces the perverse incentives that price cap regulation was designed to eliminate.

Thus, cost allocation and affiliate transaction rules are blunt instruments that should be used sparingly by regulators and only when more effective regulatory tools are not available. The Commission should make its policy decisions in this proceeding in full awareness that any consumer protection that the Commission is able to achieve through cost allocation and affiliate transaction rules carries with it a high cost in the form of lost efficiency and reduced productivity. The Notice seems oblivious to these fundamental economic facts.

In this and other recent dockets, the Commission has sought to impose rules that shift the benefit of BOC non-regulated operations to customers of regulated services on the theory that such rules are justified in order to give regulated service customers the benefits of economies of scope. Such rules are unnecessary and inappropriate. The LEC price cap plan already permits customers of regulated services to share in economies of scope. Additional rules designed to have the same effect double count these sources of productivity. Furthermore, as a legal matter, Congress and the Commission have gone to great lengths to isolate customers of regulated services from the risks associated with nonregulated operations. Under such circumstances, any gains resulting from nonregulated operations belong to shareowners, and may not be appropriated by the Commission for customers of regulated services.

The Notice acknowledges that the existing rules are sufficient to comply with the requirements of the 1996 Act. With the continued application of price cap regulation and the growth of competition in ILEC markets, the existing cost allocation and affiliate transaction rules are superfluous, and hence more than sufficient to meet the statutory mandate. Certainly nothing in the Act requires the imposition of burdensome new rules.

With regard to specific services, BellSouth agrees with the Notice that existing telemessaging services are subject to the Part 64 cost allocation rules, and Section 260 of the Act does not require that such services be provided through a separate subsidiary. BellSouth disagrees with the conclusion in the Notice that BOCs providing interLATA telemessaging services are subject to a separate subsidiary requirement. In order to avoid a serious constitutional question, the Commission should read Section 260 of the 1996 Act, which does not require a separate subsidiary for telemessaging services, as applying to interLATA as well as intraLATA provision of such services by the BOCs.

With regard to the integrated provision of interLATA telecommunications services by the BOCs, the Commission should not treat such services as nonregulated, nor should it adopt new cost allocation rules to separate exchange service and exchange access service from other regulated services. The Commission can protect customers of existing services subject to price caps from any danger of subsidizing interLATA services by excluding interLATA services from price cap regulation. Such services will be offered in competition with entrenched providers such as AT&T, MCI and Sprint, none of which are subject to price cap regulation. There is no need for the Commission to regulate the prices for interLATA services offered by the BOCs. As other BOC services become sufficiently competitive for market forces to replace regulation, these services should be removed from price cap regulation as well, and be subject to the same regulatory treatment as the Title II services of non-dominant carriers.

For those business activities that the 1996 Act requires to be conducted through a separate affiliate, the Commission's existing affiliate transaction rules are more than sufficient to protect against subsidization and discrimination. The Commission should not adopt the proposals in the Notice to apply the asymmetrical asset transfer rules to the provision of services. That proposal was raised in the 1993 *Affiliate Transaction Notice* and received extensive and intensive criticism. It has not improved with age. BellSouth retained Theodore Barry & Associates ("TB&A") to evaluate the proposed changes in the affiliate transaction rules. TB&A's analysis is attached to these comments as Appendix A. TB&A shows that requiring just three existing affiliates to perform fair market value studies for service transactions would cost BellSouth in excess of $14.4 million annually. This estimate does not include the costs associated with applying the proposed rules to services provided by other BellSouth affiliates, to new services offered by existing affiliates, or to services provided by the new affiliates required by the 1996 Act. These costs essentially would be wasted, since no additional customer protection against subsidization or discrimination would result from the adoption of the proposed requirement.

Nor should the Commission eliminate "prevailing company price" as a valuation method. Of all the valuation methods specified by the affiliate transaction rules, prevailing company price most closely conforms to the requirements of the 1996 Act that transactions be conducted on an "arms length" basis. The problems the Commission has allegedly experienced with the prevailing company price method are problems of the staff's own making. Instead of eliminating prevailing company price as a valuation method, the Commission should provide the staff with guidelines that focus enforcement efforts on transactions that may have a significant impact on prices paid by customers.

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BellSouth Corporation and BellSouth Telecommunications Inc. ("BellSouth") hereby comment on the issues raised in the Notice of Proposed Rulemaking ("Notice"), FCC 96-309, released July 18, 1996 in the captioned proceeding. For ease of reference, BellSouth has followed the order of presentation of the issues set forth in the Notice.

I. INTRODUCTION

The Notice begins by acknowledging Congress' intent that the 1996 Act be "deregulatory".[1] The existing affiliate transaction and cost allocation rules, which were designed to provide adequate protection against cross-subsidy and unreasonable discrimination, in a rate-of-return environment, are more costly and burdensome than necessary to protect customers and competitors in the current environment of expanding competition and price regulation. Were the Commission to follow the deregulatory intent of the 1996 Act, it would be scaling back the vestiges of cost of service regulation

[1] Notice, para. 1.

embedded in the existing rules. Indeed, the Notice expressly recognizes that the existing rules represent transitional safeguards, the need for which may soon vanish.[2]

Many of the proposals contained in the Notice, however, involve new, totally unnecessary regulations that would be extremely expensive to implement and burdensome to administer. Nor would the new requirements materially improve the protection against subsidization and discrimination afforded by the current Rules. As such, these proposals are contrary to the letter and the spirit of the 1996 Act, and should not be adopted.

Many of these same proposals were advanced in a 1993 rulemaking proceeding, and were roundly criticized by the overwhelming majority of commenters at that time.[3] For example, BellSouth filed a study by Theodore Barry & Associates that demonstrated that just one of the changes proposed in the *Affiliate Transaction Notice*, a requirement to estimate the fair market value of services provided between affiliates, would cost BellSouth more than $14.4 million annually, and would produce virtually no consumer

[2] Notice, para. 8 states: "We expect that once competition exists in the local exchange and exchange access services markets and incumbent local exchange carrier revenues are not dependent on costs, the need for the accounting safeguards proposed in this Notice may vanish. With the advent of competition, we can and will act to eliminate any unnecessary rules."

[3] See Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions Between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket No. 93-251, 8 FCC Rcd 8071 (1993)("*Affiliate Transaction Notice*"). The parties responding to the *Affiliate Transaction Notice* overwhelmingly recognized that the proposed rules were extremely burdensome. AT&T described the implementation costs as "staggering". AT&T Comments at 15. Sprint described the proposed rules as a "waste". Sprint Comments at 8, fn. 13. Coopers & Lybrand noted that the proposed rules "will add substantial difficulty to the Carrier's affiliate transaction process." Coopers & Lybrand Comments at 1. Even ICA and MCI, which supported adoption of the proposed rules, recognized their burdensome nature. ICA Comments at 11; MCI Comments at 14.

benefit.[4] USTA estimated the cost of performing the necessary studies by the Tier I LECs to be $91 million annually.[5] In the current Notice, the Commission again proposes this same flawed rule without even acknowledging, much less addressing, the criticisms raised by the parties in the prior proceeding. Indeed, the Commission now proposes even more onerous provisions than those advanced in the *Affiliate Transaction Notice* without any attempt at cost/benefit analysis. The proposals in the Notice are totally inconsistent with the Commission's stated intent to "continue to seek to minimize the burden our rules impose on those subject to them...."[6] As BellSouth demonstrates below, the existing cost allocation and affiliate transaction rules are more than sufficient to prevent subsidization of competitive activities of the incumbent local exchange carriers ("ILECs") and discrimination against competitors.[7]

A. Background

In the Background section of the Notice, the Commission articulates three goals for this proceeding: to protect against improper cost allocations, to allow the ILECs

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[4] *Affiliate Transaction Notice*, Reply Comments of BellSouth, Attachment, "Analysis of Proposed Use of Estimated Fair Market Value", Theodore Barry & Associates, January 10, 1994. The Theodore Barry & Associates study from the 1993 rulemaking is attached to a new Theodore Barry & Associates study, "Analysis of: Accounting Safeguards Under the Telecommunications Act of 1996" prepared for this docket and attached to these comments as Appendix A.

[5] USTA Comments at 10. USTA's estimate did not include services for which no estimated fair market value would be available, the administrative costs necessary to implement the proposal, or the costs that would be incurred by smaller LECs.

[6] Notice, para. 8.

[7] See Notice, para. 6: "The purpose of this proceeding is to establish accounting safeguards to constrain potential cost misallocation and discrimination against competitors."

realize their reasonable competitive advantages, and to ensure that consumers of the ILECs regulated services share in the carriers' economies of scope.[8]

New rules to protect consumers against cost misallocation by price cap LECs are unnecessary and inappropriate. There is no way that the Commission can mandate "proper" cost allocations, since any allocations of joint and common costs imposed by the Commission are inherently arbitrary as a matter of economics. As recently stated by Dr. Larry F. Darby, former Chief Economist and Chief of the Common Carrier Bureau of this Commission, in a companion docket:

> Market forces allocate costs retrospectively. While cost accountants practice business line accounting, those allocations provide, at best, only general guidelines for pricing. Prices of different services are determined by the market and those market-determined prices result in absorption of common costs in varying shares by various product lines. These market-determined allocations are in sharp contrast to administered cost allocations, which may be used as the basis for influencing relative prices. Prices determined under the influence of administered cost allocations will almost certainly not be the same as if determined subject only to forces in the marketplace. Nor will they have the same economic--static or dynamic--efficiency properties.[9]

When cost allocations arbitrarily imposed by regulators are used to set prices, the result is inefficient prices and a consequent loss of overall consumer welfare. Such prices also distort competitive conditions in both the regulated and unregulated markets. If regulators assign a higher share of joint and common costs to the nonregulated operations of the LEC than can be recovered through market-based prices, entry by the LECs into nonregulated operations is discouraged. Likewise, if the Commission assigns a lower level

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[8] Notice, para. 7.

[9] Larry F. Darby, Ex Parte Declaration attached to the Reply Comments of BellSouth, Allocation of Costs Associated with LEC Provision of Video Programming Services, CC Docket No. 96-112, filed June 12, 1996, pages 7-8.

of joint and common costs to regulated services than the market would assign, and then lowers regulated prices to reflect this arbitrary cost allocation, entry into the regulated markets by efficient competitors is discouraged. As a result, economic efficiency is lost and competition is distorted in both regulated and unregulated markets.

It was recognition of these basic economic facts of life that led this Commission, and most state regulatory commissions, to replace cost of service regulation, with its reliance on allocated costs to set prices, with price regulation. By breaking the link between prices and accounting costs, the Commission made it possible for prices to migrate towards more efficient levels than those produced by cost-of-service regulation. In a recent paper filed with the Commission, Dr. Lauritis R. Christensen notes:

> Once starting rates for the price-capped services have been established, prices of those services are regulated by the price cap formula, not by allocations of the telephone company's costs. Moreover, the price cap mechanism prevents telephone companies from passing cost increases through to customers via higher rates. In other words, independent of any cost increases incurred by the company, the prices paid by customers for regulated services are capped by the index. Thus, a company's investment decisions concerning broadband facilities will not affect prices for price capped services, contrary to standard practice under rate-of-return regulation.[10]

The Commission's existing cost allocation rules were designed to be sufficient to prevent cross-subsidy in a rate of return environment.[11] They are more than sufficient in a

[10] Lauritis R. Christensen, Christensen Associates, "Treatment of LEC Investments in Joint-Use Broadband Facilities Under a Price Cap Regime", Ex Parte filing by the United States Telephone Association, Allocation of Costs Associated with LEC Provision of Video Programming Services, CC Docket No. 96-112, filed July 22, 1996 ("Christensen Ex Parte"), page 2.

[11] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, Report and Order, 2 FCC Rcd 1298, 1312-14, 1335 (1987), recon., 3 FCC Rcd 6701, aff'd. sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

price cap environment, even an imperfect one.[12] The Commission has repeatedly held that the existing rules are sufficient to protect ratepayers against cross-subsidy.[13] There is no reason to change that view as a result of passage of the 1996 Act.

The second task that the Commission assigns to itself in the Notice is to allow "the BOCs and other incumbent local exchange carriers to realize their reasonable competitive advantages. . . ."[14] This task requires no action by the Commission. Absent action by the

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[12] In the Notice, the Commission asserts: "Under rate-of-return regulation, price caps with sharing (either for interstate or intrastate services), or price caps that may be adjusted in the future or if its entitlement to any revenues may be affected by the costs that it classifies as regulated, an incumbent local exchange carrier may have an incentive to misallocate to its regulated core business costs that would be properly allocated to its competitive ventures." Notice, para. 6. While there is some support for this assertion in the economic literature evaluating cost-of-service regulation, BellSouth is unaware of any studies that have attempted to validate this hypothesis in a price cap environment. Indeed, the Commission adopted price cap regulation to remove such incentives. See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6791 (1990), paras. 34-35. The use of the term "may" in the Notice admits that this assertion is speculative. In the absence of any evidence that this hypothetical incentive is sufficiently strong to affect LEC behavior, the Commission should not adopt costly new regulations based upon such speculation.

[13] See, e.g., Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I LEC Safeguards, CC Docket No. 90-623, Report and Order, 6 FCC Rcd 7571, (paras. 12-13(1991)) ("[W]e determine that our existing cost accounting safeguards . . . constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy."); Amendment of the Commission's Rules to Establish New Personal Communications Services, GEN Docket No. 90-314, Second Report and Order, 8 FCC Rcd 7700, para. 126 (1993) ("[W]e do not believe that commenters have justified imposing additional cost-accounting rules on LECs that provide PCS service."); Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, CC Docket No. 87-266, Memorandum Opinion and Order and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, para. 179(1994) ("We reject claims that we should amend Part 64 because current rules would not prevent LECs from improperly subsidizing video dialtone nonregulated services. To the contrary, we conclude that existing Part 64 rules do not require modification to prevent such an outcome.")

[14] Notice, para. 7.

Commission to prevent the LECs from achieving their reasonable competitive advantages, the LECs will have the incentive and ability to do so.[15]

The third task identified by the Commission is to ensure that consumers of the carriers' regulated services are able to share in the carriers' economies of scope.[16] Again, this task is both unnecessary and inappropriate. The LEC price cap plan already assigns to consumers of price cap services a share of the economies of scope realized by the LECs. As Dr. Christensen explains:

> Services with joint and common costs generally have "economies of scope." Economies of scope for different services occur when the cost of providing those services jointly is lower than the cost of providing them from separate facilities. If regulated and nonregulated services have joint and common costs, a company will generally have higher TFP [total factor productivity] if it offers both the regulated and nonregulated services, rather than just offering the regulated services. This is because TFP measures the ratio of Total Output to Total Input.
>
> Because the TFP growth differential is the offset to inflation in the price cap formula, higher LEC TFP growth (all other factors held constant) results in a lower ceiling on regulated prices. Thus, to the extent that joint and common facilities produce greater output of either regulated or nonregulated services, the customers of regulated services are better off.[17]

The productivity offset in the current LEC price cap formula is set higher than the LEC gain in total factor productivity measured by Dr. Christensen. Thus, consumers of regulated services are already receiving the benefit of economies of scope that result from the integrated provision of regulated and nonregulated services by the price cap LECs.

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[15] See e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, FCC 96-325, released August 8, 1996, paras. 10-11, where the Commission characterizes the LECs' incremental costs advantage over facilities based competitors as an "economic barrier to entry" and adopts rules to deprive the LECs of their competitive edge.

[16] Notice, para. 7.

[17] Christensen Ex Parte, pages 3-4.

Any attempt to assign additional "economies of scope" to regulated services customers "double counts" this source of productivity.

Finally, it would be inappropriate for the Commission to assign benefits resulting from the LECs' provision of unregulated services to regulated service customers. According to the principles established in the Democratic Central Committee case[18], the parties who bear the risk of loss are entitled to any resulting gain. The Commission has gone to great pains to insulate regulated service customers from the risks associated with LEC provision of nonregulated services. Under these circumstances, LEC shareowners, not regulated service customers, are entitled to any gain resulting from the provision of nonregulated services.

The Commission acknowledges in the Notice that with the advent of competition it is appropriate to eliminate the cost accounting rules as soon as they become "unnecessary". In the meantime, the Commission promises "to seek to minimize the burden our rules impose upon those subject to them."[19] The new rules proposed in the Notice would have precisely the opposite effect. Instead of minimizing the burden of compliance with the cost accounting and affiliate transaction rules, the proposals in the Notice would greatly increase the cost and burden of compliance with no countervailing benefit to customers of regulated LEC services. Under these circumstances, the Commission should withdraw the proposals contained in the Notice.

[18] Democratic Central Committee of the District of Columbia, et al., v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir. 1973).
[19] Notice, para. 8.

B. Specific Considerations

In paragraphs 9-16 of the Notice, the Commission addresses the specific considerations that give rise to this proceeding. One risk identified by the Commission is that the LECs might charge customers of regulated services more than the "stand-alone costs" of the services.[20] The Commission answers its own question in this regard a few paragraphs later in the Notice when it observes:

> The incumbent local exchange carrier may be reluctant to increase rates for local exchange and exchange access service if the increases would induce competitive entry in the markets in which it would otherwise continue to have market power. This would militate against the adoption of stringent accounting safeguards.[21]

"Stand-alone cost" is the cost that an efficient, single product firm would incur to produce the service in question. BellSouth and the other LECs would be foolhardy to attempt to price local exchange and exchange access services in excess of stand-alone costs. To do so would be to invite both existing and future competitors to attack an inefficient price. Even prior to the passage of the 1996 Act, the legislatures or state commissions in all nine BellSouth states had authorized local exchange and exchange access competition. Numerous local exchange competitors have emerged. Attached as Appendix B is a list of the carriers that have announced plans to provide local exchange and exchange access services in competition with BellSouth in the nine southeastern states in which BellSouth is a local exchange carrier. Many of these carriers are efficient, multi-product firms possessing economies of scale and scope that will be able to offer local exchange and exchange access services at a price significantly below "stand-alone costs". BellSouth will

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[20] Notice, para. 9.
[21] Notice, para. 13.

be forced to compete with these carriers or surrender market share. Under these circumstances, the adoption of additional accounting safeguards (indeed, the prolonged retention of the existing accounting safeguards) intended to prevent the LECs from pricing local exchange or exchange access services in excess of "stand-alone costs" is entirely superfluous.

The Commission also recognizes that the incentive to shift costs from regulated to nonregulated services is a rational strategy only "if such shifting permits the carrier to increase the rates for these regulated services."[22] Again, the facts belie any such ability. BellSouth and the other price cap LECs are subject to price cap regulation in the interstate jurisdiction. As discussed above, the LEC price cap plan was adopted specifically to reduce, if not eliminate entirely, both the incentive and ability to engage in such cost shifting. BellSouth is also subject to price cap regulation in all nine of its intrastate jurisdictions. Even for those LECs still subject to rate of return regulation in one or both jurisdictions, the likelihood of cost-shifting on any significant scale is remote and would be easily detected if attempted. As the Commission notes:

> [W]hile an incumbent local exchange carrier may possess the legal ability to raise rates in the regulated market to subsidize its competitive activities, the threat of entry into the regulated market may prevent it from doing so. Even if such subsidization were to allow a BOC or other incumbent local exchange carrier to sustain prices below costs for a period of time sufficient to drive out competing IXCs, the local exchange carrier would be unlikely to raise prices above the competitive level, since each IXC's network represents an embedded facility which could be purchased in a bankruptcy proceeding and used if the local exchange carrier affiliates subsequently attempted to raise prices above the competitive level.[23]

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[22] Notice, para. 13.
[23] Notice, para. 16.

Because such "predatory pricing" is essentially illogical and counter-productive, the Commission correctly concludes that such behavior "by a BOC or incumbent local exchange carrier is unlikely to occur."[24] Under these circumstances, prophylactic rules to prevent such conduct are unnecessary, and should not be adopted.

The other concern expressed in this section of the Notice deals with discrimination against competing carriers.[25] Cost allocation and affiliate transaction rules are not necessary to address these concerns. Both the statute and other Commission rules effectively prohibit such discrimination. The Commission's concern about carriers favoring affiliates with a lower "price of access" than offered to a competing carrier are addressed by the Commission's requirement that interstate access charges be offered pursuant to tariff on a nondiscriminatory basis. To the extent that the Commission is concerned that unbundled network elements will be substituted for access charges, the 1996 Act also contains a nondiscrimination requirement applicable to such elements. The sophisticated purchasers of access services and unbundled network elements would be quick to detect and complain if any incumbent LEC attempted to favor its interexchange carrier affiliate in this regard. The Notice does not explain how new affiliate transaction rules would add any material level of protection to that provided by the 1996 Act itself. The same may be said for service quality discrimination. Not only would such discrimination be easy to detect by sophisticated users of access services (or unbundled network elements), but such discrimination is expressly prohibited by the 1996 Act. No new rules are necessary to deal with potential service quality discrimination. Finally, the

[24] Notice, para. 16.
[25] Notice, para. 15.

Notice identifies the possibility of discrimination in favor of manufacturing affiliates in the purchase of goods and services. Of course, no Bell Operating Company has a manufacturing affiliate because of the AT&T Consent Decree. However, both GTE and the Sprint telephone companies have supply affiliates. No claims of discriminatory purchasing practices have been adjudicated against these incumbent LECs. In light of the extensive safeguards contained in Section 273 of the 1996 Act, the risk of discrimination by a Bell Operating Company in favor of a manufacturing affiliate is remote, and would be easily detected if it occurred. The existing cost allocation and affiliate transaction rules are superfluous, and no additional rules by the Commission are required in this area.

II. SAFEGUARDS FOR INTEGRATED OPERATIONS

A. General

In the Notice, the Commission tentatively concludes that its existing Part 64 cost allocation rules satisfy the requirements of the 1996 Act that subscribers to regulated telecommunications services not subsidize telemessaging, certain interLATA telecommunications and information, alarm monitoring and payphone services that the BOCs and other ILECs are permitted to offer on an integrated basis.[26] BellSouth believes that the existing rules are more than sufficient to meet the requirements of the 1996 Act in this regard. For the most part, these are services that the BOCs and/or other ILECs were permitted to offer prior to the 1996 Act. No party has successfully contended that the existing rules are insufficient to prevent subsidization of these services by subscribers to regulated telecommunications services. The Notice is also correct in recognizing the rules developed in the *Joint Cost* and *Computer III Proceedings* have been effective in ensuring

[26] Notice, para. 27.

that regulated service ratepayers do not bear the costs and risks of the telephone companies' nonregulated activities. The ILECs have developed and implemented internal cost allocation systems to ensure compliance with these rules. The efficacy of these systems have been tested repeatedly in audits by both the Commission staff, state regulators and independent auditors. These systems are sufficient to protect ratepayers against harm through subsidization of ILEC nonregulated activities. The Commission is also correct when it states that redesigning these systems to implement different cost allocation rules would impose substantial administrative and financial costs on the carriers.[27]

For those ILECs subject to price cap regulation, there is sufficient protection for regulated service customers even in the absence of the *Joint Cost* and *Computer III* safeguards. Price cap regulation breaks the link between prices and accounting costs (and hence allocated costs). For carriers such as BellSouth that have been subject to price cap regulation in the interstate jurisdiction since 1990, the limited pricing flexibility afforded by the interstate price cap rules has permitted prices to migrate from those established on the basis of allocated costs to more efficient and rational prices. For such carriers, the cost allocation rules have only a tenuous connection with prices charged to regulated service customers. The Commission could eliminate the existing cost allocation rules for such carriers with virtually no impact on customers of regulated services.[28]

[27] Notice, para. 28.
[28] Notice, para. 11.

B. Specific Services

1. Section 260 - Telemessaging Service

a. Statutory Language

BellSouth concurs with the tentative conclusion reached in the Notice that the existing Part 64 Rules apply to BOC provision of telemessaging services.[29] These rules are more than sufficient to safeguard against the subsidies prohibited by Section 260(a)(1) of the 1996 Act. BellSouth also agrees with the conclusion that Section 260 does not impose a separate subsidiary requirement for ILEC provision of telemessaging services on an integrated basis.[30] Under these circumstances, there is no need for the Commission to interpret Section 272 as requiring a separate subsidiary for BOC provision of interLATA telemessaging services.

The imposition of a separate subsidiary requirement that affects speech should not be undertaken absent an express directive by Congress. In comments filed August 15, 1996 in response to the *BOC In-Region NPRM*, BellSouth set out in detail its analysis of the constitutional and statutory provisions applicable to BOC provision of interLATA information services.[31] There BellSouth demonstrated that information services are a form of commercial speech protected by the First Amendment, and that a separate affiliate requirement is a form of prior restraint that must be limited to the narrowest class of services for which there is a compelling government need for the restraint. In connection

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[29] Notice, para. 33.

[30] Id.

[31] Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, CC Docket No. 96-149 ("*BOC In-Region NPRM*"), Comments of BellSouth (August 15, 1996), at 20-28.

with BOC provision of interLATA information services there is no such compelling need, since Congress and the Commission have not found it necessary to impose a separate subsidiary requirement on other large ILECs that are similarly situated to the BOCs.

Although the Commission has no discretion to ignore Congress' mandate of a separate subsidiary requirement for in-region interLATA information services, the Commission can avoid a constitutional issue by construing Section 260 as the provision of the 1996 Act governing telemessaging services, and not imposing a separate subsidiary requirement on BOC provision of interLATA telemessaging services.

b. Scope of Commission's Authority

Section 260 of the 1996 Act imposes safeguards regarding the provision of telemessaging services by ILECs. The Commission has tentatively concluded that its existing Part 64 Rules are sufficient to protect against the conduct proscribed by Section 260.[32] Since the Commission's Part 64 Rules are applied prior to the Part 36 jurisdictional separations rules, the safeguards provided by the Commission's Rules will safeguard consumers of both interstate and intrastate services.[33] There is, therefore, neither a need nor a basis in law for the Commission to preempt state commission actions that are consistent with Section 260 and the Part 64 Rules.

2. Section 271 - InterLATA Telecommunications Services

a. Incidental InterLATA Services

The Notice asks whether the existing Part 64 Rules are sufficient to protect telephone exchange service ratepayers or competition in any telecommunications market

[32] Notice, para. 33.
[33] Notice, para. 36.

in connection with BOC provision of incidental interLATA services.[34] As discussed previously, the existing rules are more than sufficient to perform such a function. Indeed, in a price cap environment, the existing Part 64 Rules are superfluous. The Commission can and should forbear from applying the Part 64 Rules to ILECs that are subject to price cap regulation in both the interstate and intrastate jurisdictions.[35]

b. Integrated Provision of InterLATA Services

The Notice seeks comment on appropriate safeguards should a BOC decide to offer out-of-region interLATA services on an integrated basis with its in-region regulated telecommunications services. The Notice suggests that new cost allocation rules would be required to guard against cross-subsidy. The tentative conclusion reached is that the Commission should apply cost allocation rules to services other than local exchange and exchange access services provided on an integrated basis. The Commission seeks comment on whether it should require the creation of a separate cost allocation category for regulated services other than local exchange and exchange access services within the BOCs internal cost allocation systems. Alternatively, the Commission seeks comment on whether it should consider any services provided on an integrated basis with exchange service and exchange access service as nonregulated for Title II accounting purposes.[36]

Neither of the alternatives discussed in the Notice is necessary or appropriate. It would be arbitrary and capricious for the Commission to classify regulated

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[34] Notice, paras. 37-38.

[35] Section 10 of the 1996 Act requires the Commission to forbear from applying any of its regulations or any provisions of the Telecommunications Act to telecommunications carriers and telecommunications services if enforcement of such requirement or regulation is not necessary to protect competition, consumers or the public interest.

[36] Notice, para. 39.

services as non-regulated for the sole purpose of imposing cost allocation rules. Indeed, there is no reason for the Commission to do so. Regulated services are subject to tariff filing requirements, and the Commission can review the cost of providing such services, including the allocation of overheads to such services, in the tariff review process.

The Commission can protect customers of interstate services subject to price cap regulation from any danger of subsidizing out-of-region interLATA services by simply excluding the latter from price caps. This will ensure that the rates charged by customers of BOC interstate access services are unaffected by BOC provision of out-of-region interLATA services. Absent the ability of the prices charged for out-of-region interLATA services to raise the price cap index, no subsidization by price capped services is possible. This is the course of action taken by the Commission in the AT&T price cap plan. As categories of services were deemed sufficiently competitive to no longer require the application of price cap regulation, these services were dropped from the price cap plan.

c. Other Matters

The Notice seeks comment on how to account for imputed access charges under Section 272(e)(3).[37] The proposal contained at Paragraph 41 would require a change to the Part 32 Rules. Section 32.5280(b) of the Rules states: "This account shall be debited and regulated revenue accounts shall be credited at tariffed rates when tariffed services are provided to nonregulated activities that are accounted for as prescribed in § 32.23(c) of this subpart." The current rule is a more appropriate treatment of charges against one integrated line of business that also represents revenue to a second integrated line of business. To use the account treatment proposed in the Notice would overstate both the

[37] Notice, para. 41.